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No. 73-1409

In the
Supreme Court of the United States
OCTOBER TERM, 1973

JOHN J. WASNOWIC and KEYSTONE TRADERS, INC.,

Petitioners,

vs.

CHICAGO BOARD OF TRADE and CHICAGO MERCANTILE EXCHANGE,

Respondents.

BRIEF OF RESPONDENTS CHICAGO BOARD OF TRADE AND CHICAGO MERCANTILE EXCHANGE IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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Respondents Chicago Board of Trade and Chicago Mercantile Exchange (hereinafter referred to as the "Exchanges"), submit that the petition for writ of certiorari is without merit and should be denied.

QUESTION PRESENTED

This case does not raise the "Questions Presented" framed in the petition (p. 5). The sole question presented is whether the lower courts committed reversible error in ruling that the following allegations do not state a

claim *against the Exchanges* under the federal securities laws

(1) petitioners, by separate and independent action, gave authority to J.S. Sicherman, a commodity broker, to buy and sell commodity futures contracts in his discretion for their respective accounts;[1]

(2) instead of using that authority Sicherman converted petitioners' funds to other uses and concealed his activity by issuing false reports showing fictitious and pretended trades; and

(3) the two Exchanges, where Sicherman was a member, failed to discover his wrongdoing.

Petitioners brought this action in their home district knowing that the Exchanges could not be served with process there and that long-arm service was not authorized by the Commodity Exchange Act, their principal basis for suit. Instead, they sought extraterritorial service under §27 of the Securities Exchange Act on the theory that the same allegations used to show a violation of the Commodity Exchange Act also stated a claim against the Exchanges under the Securities Act of 1933 and the Securities Exchange Act of 1934. We submit that the District Court and the Third Circuit were correct in ruling that the allegations of the complaint do not involve a violation of the federal securities laws *by the Exchanges*.

No "subsidiary question" exists concerning petitioners' right to amend their complaint (p. 5). Those amendments

[1] Had the complaint been formally amended to recite that petitioner Keystone Traders, Inc. was an investment company, this allegation would remain accurately stated.

sought in various ways to show a new and different fraud, pre-dating the opening of commodity accounts, in which Sicherman sold shares in Keystone Traders and another corporate entity to the public. The courts below reviewed the complaint as if it had been amended (A23-24) and concluded that, whatever might be the relationship between investors in these separate companies and Sicherman, these allegations concerned activities which were too remote from the operations and duties of the Exchanges to establish jurisdiction under the federal securities laws.

STATEMENT OF THE CASE

Petitioners' Statement (pp. 6-9) contains a number of inaccuracies. For example, no allegation in the complaint supports petitioners' statement that "all investment decisions were made solely by Sicherman, as agreed by the parties" (p. 6). Rather than burden the Court with a separate Statement, we have set forth the necessary factual background for each issue discussed.

REASONS FOR DENYING THE WRIT

Petitioners' arguments for granting a writ are without merit. The issue that they consider to be critical—whether discretionary commodity accounts are "investment contracts"—was recently presented in *Milnarik* v. *M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir. 1972), which this Court declined to review. 409 U.S. 887 (1972). Nothing has since happened to warrant a different result. Moreover, even were that issue resolved in petitioners' favor, the complaint would not state a claim *against the Exchanges* under the federal securities laws unless the Third Circuit suddenly reversed its position that mere failure of the Exchanges to discover Sicherman's wrongdoing does not constitute "aiding and abetting" the fraud.

The rulings below neither conflict with the prior decisions of the Supreme Court nor with the decision of any other Circuit. Although a district court has chosen to reject the decisions of the Seventh Circuit in *Milnarik* and the Third Circuit in this case, that is not sufficient reason to bypass the normal appellate procedures for the reconciliation of trial court decisions.

I. The Rulings Below Are Entirely Consistent With the Supreme Court's Definition of an "Investment Contract."

Petitioners endeavor to show a conflict between the decisions below and this Court's definition of an "investment contract." To create the appearance of conflict, petitioners mischaracterize the decisions below as stating that an investment contract does not exist unless there is a pooling or commingling of investors' funds (pp. 10, 12). A fair reading of the District Court's decision shows, instead, that it properly insisted that "commonality" must

exist, and merely cited the pooling or commingling of funds as evidence of a "joint enterprise" (A14-15). The lower courts found that the petitioners' discretionary commodity accounts were not a "common enterprise" because they were wholly independent of each other in their ownership, in their operation, and in their success or failure (A13-15).

The decisions below applied the concept of "common enterprise" embodied in this Court's definition of an "investment contract" under the federal securities laws. Every Supreme Court decision has involved a scheme where either the costs of operation or the risks of ownership of a profit-seeking venture have been spread by the offering or sale of interests to investors. That is the clear meaning of *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946):

> In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise . . . .

Petitioners, however, misstate the facts and legal principles of this Court's prior holdings trying to create the appearance of conflict. Especially misleading is their assertion that *Howey* merely concerned the sale of individual parcels of land to separate and unrelated buyers (p. 12-13). On the contrary, the "common enterprise" in *Howey* was a citrus grove in which over 40 widely-scattered investors, by contributing operating capital, received documents called "warranty deeds" entitling them to share in

the profits from the pooled sale of the grove's fruit. This Court expressly noted that the warranty deeds were simply "a convenient method of determining the investors' allocable shares of the profits" and "the resulting transfer of rights in land is purely incidental." The "individual plots could only be developed as component parts of a larger area." 328 U.S. at 300.

In *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), the common enterprise was an oil exploration venture which roughly 50 persons helped to finance by purchase of "leaseholds" whose value depended upon the success of the venture. Most recently, in *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967), the requisite common enterprise was a lending institution to which over 5,000 persons contributed capital and received withdrawable capital shares paying dividends on the institution's net profits.

A discretionary commodity account has none of the characteristics of a common enterprise, as was explained in *Milnarik* v. *M-S Commodities, Inc.*, 457 F.2d 274, 278 (7th Cir. 1972):

> This characteristic of common enterprise is completely lacking in the present case. Even assuming that Nelson in fact solicited and collected money from numerous parties, no allegations are made that a common enterprise existed comprised of all people possessing discretionary account contracts with him. No claim is made that Nelson traded in a uniform manner for each of these accounts. Even if he had so uniformly traded, no pooling of funds for a common purpose is alleged. Nelson was apparently simply an agent for a number of separate and distinct principals, the plaintiffs being one such principal. The plaintiffs in no way can be viewed as having invested in a common enterprise with other suppliers of venture capital. Without such common investment, the property sale cases are not analogous.

Rather, a discretionary commodity account is wholly independent and unrelated in its ownership or its prospects for success to any other account:

> We find the element of commonality absent here. Although the complaint does allege that Nelson entered into similar discretionary arrangements with other customers, the success or failure of those other contracts had no direct impact on the profitability of plaintiffs' contract. Nelson's various customers were represented by a common agent, but they were not joint participants in the same investment enterprise.
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> • • •
>
> In essence, this contract creates an agency-for-hire rather than constituting the sale of a unit of a larger enterprise. No matter how many different persons Nelson became an agent for under similar or even identical discretionary contracts, his relationship with each would remain as that of agent and principal. Each contract creating this relationship is unitary in nature and each will be a success or failure without regard to the others. Some may show a profit, some a loss, but they are independent of each other. (457 F.2d at 276-77).

The District Court in the present case found that the discretionary commodity accounts of petitioners' were the same as in *Milnarik* (A14), and ruled that they did not constitute "investment contracts."

Petitioners argue, without support, that a "common enterprise" can exist where the venture is wholly owned by a single person, if the efforts of third parties are important to that person's profit (p. 15). Every case cited, however, involved schemes with more than one investor (the term "investor" implies participation with others) and in which the courts pierced the promoter's efforts to create the illusion of separate transactions with individual purchasers. The forty separate "warranty

deeds" in *Howey* were found to be a subterfuge because the parcels of land "purchased" were too small for economical farming, entry to the land was forbidden, and the purchaser had no claim to specific fruit but shared in the income from a pooled sale of all fruit. (328 U.S. at 295-96). At least nine investors were involved in *Blackwell* v. *Bentsen*, 203 F.2d 690 (5th Cir. 1953), a program similar to *Howey*, which the promoters themselves described as "for the joint benefit of all investors." Thousands of persons were involved in *SEC* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973), where Turner disguised the sale of interests in his business by offering "self-improvement courses" entitling the purchasers to share thereafter in the income Turner received from subsequent sales of the "courses."[2] Accordingly, no decisions are cited which equate a "common enterprise" with a venture wholly owned by a single investor, such as the separate commodity accounts owned exclusively by each petitioner.

II. No Conflict Exists Between the Circuits.

There is no conflict between the Circuits on the issue whether a discretionary commodity account is an "investment contract" or other security under the Securities Act of 1933 or the Securities Exchange Act of 1934. Only the Seventh and Third Circuits have adjudicated the question and both have ruled that such accounts are not securities. *Milnarik* v. *M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.) *cert. denied*, 409 U.S. 887 (1972); and

[2] A district court in the Ninth Circuit has held *Turner* inapplicable to discretionary commodity accounts because the "widespread promotional scheme under which investors were induced to purchase" interests in Turner's enterprise was not remotely similar to "an ordinary brokerage agreement." (*Stuckey* v. *duPont Glore Forgan, Inc.*, 59 F.R.D. 129, 131 (N.D. Cal. 1973).

Wasnowic v. *Chicago Board of Trade* (3d Cir., December 21, 1973), *aff'g*, 352 F. Supp. 1066 (M.D. Pa. 1972).

Two cases are cited by petitioners to demonstrate a "conflict" but neither has that effect. One decision is *Commercial Iron & Metal Co.* v. *Bache & Co., Inc.*, 478 F.2d 39 (10th Cir. 1972). Far from ruling that discretionary commodity accounts are securities, the Tenth Circuit in *Commercial Iron* declined to pass upon the issue:

> We must emphasize that we are in no manner implying that Commercial's agreement with Bache constituted an investment contract. At this stage of the proceeding we do not have the evidence before us to make such a determination. Our decision only states that appellant's complaint and affidavit allege issues of material fact which cannot be resolved without further proceedings. (478 F.2d at 43).

Moreover, the account in *Commercial* did not involve commodity futures contracts, but rather instruments created by Bache itself and offered to customers as an investment in electrolytic copper owned by Bache.

The other case cited by petitioners is the Eighth Circuit's opinion in *Booth* v. *Peavey Company Commodity Services*, 430 F.2d 132 (8th Cir. 1970). The issue was whether the plaintiff's account had been "churned." A directed verdict for the broker was granted on substantial evidence that the account was not truly "discretionary." The Eighth Circuit noted that the broker and customer talked by telephone eighty-one times on forty-five days when the trading was occurring (430 F.2d at 134), and that the customer described trades made without such communication to be "unauthorized." (430 F.2d at 135). What petitioners focus upon, instead, is *dictum* by the Eighth Circuit compiling earlier district court decisions and stating that commodity churning cases might be

brought under either the Commodity Exchange Act or the federal securities laws. The Eighth Circuit admitted that the comment was gratuitous since "the point was not argued by the parties" (430 F.2d at 133). Moreover, its statement predated the more thorough analysis made by the Seventh Circuit in *Milnarik* and the later decisions following *Milnarik*.[2]

Consequently, neither *Booth* nor *Commercial Iron* support petitioners' contention that a "conflict" exists with the decisions of the Seventh and Third Circuits.

The district court in *Marshall* v. *Lamson Bros. & Co.*, 368 F.Supp. 486 (S.D. Iowa 1974) has rejected the reasoning in *Milnarik* and the present case, but that is no basis for granting a writ of certiorari. The respective Courts of Appeals should first be given the opportunity to resolve such conflicts, before review by the Supreme Court.

III. The Lower Courts Properly Held That Amendment of the Complaint Would Not Provide Jurisdiction Over the Exchanges.

Failing to secure long-arm jurisdiction over the Exchanges pursuant to the federal securities laws with respect to Sicherman's conversion of funds from discretionary commodity accounts, petitioners sought to amend their complaint to charge Sicherman with fraud in the formation of certain corporations, including petitioner Keystone Traders, Inc. The nature of the fraud, defined in subsequent attempts by petitioners to amend, involved misrepresentations by Sicherman as to the character, worth and purpose of the corporations whose shares he was selling. (A20-25). The District Court ruled upon the complaint as if amended, holding that the nature of the

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[2] See *Stuckey* v. *duPont Glore Forgan, Inc.*, 59 F.R.D. 129 (N.D. Calif. 1973).

relationship between these corporations and their stockholders was "totally unrelated" to the alleged existence of a "security" which would confer jurisdiction over the Exchanges (A16-17). When petitioners renewed their motion to amend the complaint, the District Court pointed out again that the relationship of shareholders to the corporations that invested funds in discretionary trading accounts was not the "investment contract" on which petitioners (necessarily) relied to establish jurisdiction *over the Exchanges*. There is no basis to disturb the determination that amendment of the complaint would not cure its deficiencies.

IV. The Court of Appeals Properly Affirmed Dismissal of the Complaint Because It Fails To State a Claim Against the Exchange For "Aiding And Abetting" Sicherman's Alleged Violations of the Federal Securities Laws.

The Exchanges moved the District Court to dismiss the complaint because petitioners charged only that the Exchanges negligently failed to supervise Sicherman's activities or detect his fraud, and these allegations did not support the conclusion that the Exchanges aided and abetted Sicherman's violations. The District Court, however, accepted petitioners' use of the phrase "aiding and abetting" as sufficient to state a claim against the Exchanges. On appeal to the Third Circuit, the Exchanges contended that the dismissal should be affirmed because the facts alleged in the complaint were not sufficient to state a claim against them for aiding and abetting.[4]

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[4] On a motion to dismiss, the sufficiency of the complaint must be tested against the well-pleaded facts, not conclusions of the pleader. *Pacific States Box & Basket Co.* v. *White*, 296 U.S. 176, 185 (1935); *Newport News Shipbuilding & Dry Dock Co.* v. *Shauffler*, 303 U.S. 54 (1938).

A. The Insufficiency of the Complaint Is a Proper Basis For Denying Certiorari.

This Court has repeatedly held that "a successful party in the District Court may sustain its judgment on any ground that finds support in the record." *Jaffke* v. *Dunham*, 352 U.S. 280, 281 (1957); *United States* v. *American Railway Express Co.*, 265 U.S. 425, 435 (1924); *Jamesbury Corp.* v. *Worcester Valve Co.*, 453 F.2d 205 (1st Cir. 1971). Since the complaint contains no factual allegations that the Exchanges knowingly assisted in Sicherman's alleged fraud, it did not state a claim under the legal principles announced by this Court and the Third Circuit. Accordingly, there is no reason to disturb the decisions of the lower courts, regardless of the holding that discretionary commodity accounts are not investment contracts.

B. The Complaint Was Deficient Because It Contained No Allegation That the Exchanges Knowingly Participated in Sicherman's Alleged Fraudulent Conduct.

The Third Circuit has recently declared that a defendant cannot be held to answer as an aider and abettor of fraudulent conduct absent some allegation of *knowing participation* on its part. In *Landy* v. *Federal Deposit Insurance Corp.*, 486 F.2d 139 (3d Cir. 1973), *cert. pending*, No. 73-819, the Third Circuit defined the elements that must be alleged and proven to constitute "aiding and abetting" in a securities fraud case as follows:

> Three elements are thus required for liability: (1) that an independent wrong exist; (2) that the aider or abettor know of that wrong's existence; and (3) that substantial assistance be given in effecting that wrong. 486 F.2d at 162-63.

Given this precedent, the Third Circuit's affirmance should be viewed as premised, in part, on a determination that

the complaint should be dismissed for failure to state a claim.

Judged against the well established standards for what constitutes aiding and abetting, the complaint was plainly insufficient. As this Court stressed in *Nye & Nissen* v. *United States*, 336 U.S. 613, 619 (1949):

> In order to aid and abet another to commit a crime it is necessary that a defendant "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed."

These prerequisities to liability for aiding and abetting have been consistently applied to charges of fraud under the federal securities laws. *E.g.*, *Brennan* v. *Midwestern United Life Insurance Co.*, 259 F.Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147, 153-154 (7th Cir. 1969); *Hochfelder* v. *Midwest Stock Exchange*, 350 F.Supp. 1122 (N.D. Ill. 1972); *Wessel* v. *Buhler*, 437 F.2d 279, 283 (9th Cir. 1971). The Ninth Circuit recently held in *Strong* v. *France*, 474 F.2d 747, 752 (1973), that inaction does not support a claim of "aiding and abetting" unless it is designed to conceal a fraud known to the inactive party.

Accordingly, even were the complaint found to state a claim of "securities" fraud against Sicherman, it would remain insufficient to charge the Exchanges with having "aided or abetted" the violation by their mere failure to discover his fraud. The decisions below should be sustained on this ground.

V. The Theory Underlying Petitioners' Complaint Would Impair Public Policy by Confusing the Separate Regulatory Schemes Established by Congress For Securities and Commodities.

Any claim against the Exchanges for Sicherman's misappropriation of funds arises under the Commodity Ex-

change Act. It is apparent, though, that petitioners have invoked the federal securities laws in an effort to maintain their action in the Middle District of Pennsylvania where long-arm service on the Exchanges was required. Dismissal of the complaint merely confirmed that petitioners elected to sue the Exchanges in the wrong forum and prevented blurring of the sharp differentiation made by Congress between regulation of futures trading and regulation of securities transactions.

The Commodity Exchange Act (7 U.S.C. §§1 et seq.) vests regulation of commodity brokers and the Exchanges, as contract markets, in the Secretary of Agriculture ("Secretary") and an independent agency, the Commodity Exchange Commission ("Commission"). Pursuant to the Commodity Exchange Act, the Secretary has promulgated extensive rules and regulations (see 17 C.F.R. §§1 et seq.) and has organized the Commodity Exchange Authority, to supervise daily activities of licensed futures commission merchants and contract markets.

On the other hand, the Securities Act of 1933 and the Securities Exchange Act of 1934 were adopted to govern securities transactions, broker-dealers in securities and stock exchanges. The Securities and Exchange Commission has no status or role under the Commodity Exchange Act. It does not purport to involve itself in the supervision of commodity futures trading or in the regulation of futures commission merchants and contract market.[5]

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[5] Indeed, *Milnarik's* ruling that discretionary commodity accounts are not "investment contracts" has been cited by the Securities and Exchange Commission under its "no action letter" procedure. *CBWL-Hayden Stone, Inc.*, 1972-73 CCH Fed. Sec. L. Rep., ¶79,262 (Feb. 2, 1973).

Petitioners claim to have a private right of action under the Commodity Exchange Act against Sicherman for his conversion of customer funds and against the Exchanges for the alleged violation of their self-regulatory duty to prevent Sicherman's misconduct. See *Goodman* v. *H. Hentz & Co.*, 265 F. Supp. 440, 446-447 (N.D. Ill. 1967). The absence of a claim under the securities laws affects only the forum in which plaintiffs must pursue their remedies.

CONCLUSION

For the foregoing reasons, we submit that the petition should be denied.

Respectfully submitted,

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